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Do Special Districts Affect Cities' GO Ratings?

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Municipalities often ask Standard & Poor's: "If we allow the formation of a special district within our boundaries, with debt issuing powers, could our general obligation rating be downgraded?"

While there can be no blanket answer, municipalities may find comfort in the fact that most real-world examples do not result in a change to a GO rating.

That is not to say that special districts do not pose challenges to municipalities that sponsor or oversee special district formation. Overly aggressive development plans that overstate demand could saddle a district with an onerous debt burden that may actually hinder growth. Likewise, creation of a number of overlapping special purpose districts could result in steadily rising tax rates if tax base growth does not keep pace with debt issuance, although usually high debt special districts are sparsely populated. Good management practice will screen potential new special districts for viability. Special district debt could present negative implications to GO ratings in certain situations. These implications can range from the expenditure of management resources in a workout of a troubled district to a financial bailout to avoid a default.

Types of Special Districts

Two main types of special districts exist, each with different credit risks to bondholders and overlapping municipalities. The first type, consisting of special assessment, Mello-Roos, or unlimited tax GO districts, impose an additional tax on residents over and above the municipality's current tax rate. The second type, tax increment districts, don't impose additional taxes but reallocate taxes at existing tax rates to a redevelopment district.

Generally, the tax burden of newly created special districts falls on undeveloped land with little current value. Thus, a bankruptcy of a special district usually affects few taxpayers (often a single developer) and puts only a very small portion of a municipality's larger tax base at risk. Special district bankruptcies in Colorado in the late 1980s, and in California in the 1990s, had little impact generally on overlapping cities, counties, and school districts, despite debt-to-value ratios within some of the special taxing districts of almost 1:1.

However, theoretically, a bankruptcy of a large and developed special district--for example one with 5% or more of a jurisdiction's tax base--could raise substantially the tax burden of the greater citizenry and create significant tax delinquencies for the overlapping municipality. In such a case, a municipality's credit rating might conceivably be affected by a special district default--although a large developed special district is more likely to be creditworthy, and avoid a default, in the first place.

Tax increment districts pose a slightly different case. By definition, they do not raise additional taxes; they merely redistribute to a redevelopment agency taxes on new assessed valuation that would otherwise go to overlapping taxing entities. An increment district's inability to cover its debt service does not affect an overlapping municipality's ability to tax the base assessed valuation of a tax increment district, unless property values fall below the base, and tax rates do not rise. Nevertheless, overlapping jurisdictions may find themselves squeezed for funds over a long time period to the extent that tax increment districts freeze overlapping taxing entities' assessed valuation and tax revenues do not grow adequately to cover future needs. The risk is greatest when tax increment districts cover (or smother) areas comprising substantial portions of an entity's tax base. These concerns have caused counties and school districts in some cases to oppose the formation of tax increment districts, unless tax increment revenues are "passed through" to the objecting government.

One happy compromise between a tax increment district and overlapping districts, such as school districts, is to use subordinated "pass-through" agreements. The tax increment agency pledges not to use the tax increment revenues "passed through" to a school district when sizing its debt. However, the school district allows its pass-through revenues to be pledged to tax increment bondholders. The extra coverage provided on the "pass through" allows higher tax increment bond ratings, yet the school district gets its tax revenues, unless assessed valuation in the district drops.

In summary, municipalities fear special districts may play havoc with their overlapping debt ratios. Standard & Poor's includes all overlapping taxing entities when calculating its standard debt ratios. However, analysts are experienced enough to examine also debt ratios without including special district debt, if the districts put only tiny fractions of the tax base at risk.

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